

MEMORANDUM OF LAW

DATE: October 23, 1991

TO: Doug McCalla, via Larry Grissom, Retirement Administrator

FROM: City Attorney

SUBJECT: Third Amended Agreement Between CERS and Pacific Investment Management Company "Soft Dollar and Directed Brokerage Arrangements"

Pursuant to your request dated September 23, 1991, I have reviewed the Third Amendment to Agreement between CERS and Pacific Investment Management Company ("PIMCO"). I have also reviewed Government Code section 6930 concerning "governmental investors" and "soft dollar and directed brokerage arrangements" which became effective January 1, 1991. My observations follow.

Effective January 1, 1991, Chapter 11.5 (commencing with Government Code section 6930 and ending with Government Code section 6934) was added to the Government Code relating to Governmental Investors. Generally, Government Code section 6931 requires each securities transaction or brokerage agreement carried out for a governmental investor pursuant to a soft dollar and directed brokerage arrangement to be executed at the lowest responsible transaction cost available. In addition, Government Code section 6932 requires that any written contract entered into between a governmental investor and an investment manager on or after January 1, 1991, for the management of assets of a public fund or a public pension or retirement fund, which includes a soft dollar and directed brokerage arrangement contain specified requirements relating to soft dollar and directed brokerage arrangements. Importantly, Government Code section 6934 states that "this chapter shall apply to contracts entered into, renewed or extended on and after January 1, 1991."

Under Government Code section 6930(a), a "governmental investor" is defined as "each public governing or investing body or public investing officer, who exercises investment discretion over public funds in excess of ten million dollars (\$10,000,000) or over public pension or retirement funds in excess of ten million dollars (\$10,000,000)." CERS, by definition, is a governmental investor. Government Code section 6930(b) defines "soft dollar and directed brokerage arrangements" as "the brokerage and research services described by Section 28(e) of the Securities Exchange Act of 1934 (15 U.S.C. section 78bb(e))." "Transaction cost" is defined as "the overall cost of the transaction,

including, but not limited to, commissions, services, and the price of the securities." Government Code section 6930(c). Finally, the term "responsible" for purposes of this Chapter, "means with the due diligence required of a fiduciary to examine a presented transaction for: necessity of soft dollar services provided and for commission cost; quality of the trade; quality of the broker-dealer's research; the broker-dealer's execution capabilities; and the broker-dealer's quality of service."

Due to the above-described changes in the California Government Code, PIMCO submitted the Third Amendment to Agreement to satisfy the requirements set forth in Government Code section 6932 relating to soft dollar and directed brokerage arrangements. Government Code section 6932 provides:

- (a) The investment manager shall maintain complete and detailed records of all billed services provided pursuant to soft dollar and directed brokerage arrangements.
- (b) The services which may be provided by a broker-dealer pursuant to soft dollar and directed brokerage arrangements shall be clearly defined.
- (c) The investment manager shall, in the customer agreement letters with governmental investors, disclose:
 - (1) A list of all billed services provided pursuant to soft dollar and directed brokerage arrangements with respect to investment transactions for the governmental investor.
 - (2) The justification for providing each of those services.
 - (3) The maximum percentage of the investment transactions of the governmental investor planned for use in soft dollar and directed brokerage arrangements.
 - (4) An annual statement of all billed services provided during the previous year under soft dollar and directed brokerage arrangements with respect to investment transactions for the governmental investor.
 - (5) A determination of whether each service provided under soft dollar and directed brokerage arrangements with respect to investment transactions for the governmental investor is proprietary or is being shared by other clients of the investment manager.

For the most part, PIMCO's proposed amendment is identical to the statutory language in Government Code section 6932(c)(1)-(5) set forth above. PIMCO has made one, perhaps minor change. Government Code section 6932(c) states that the investment manager (PIMCO) shall, in the customer agreement letters with governmental investors (CERS) provide the information listed in subdivisions (1)-(5) of this section. (Emphasis

added.) PIMCO's amendment proposes to satisfy this requirement by annually providing a list of the required information. This change does not appear to have any legal significance. It is unknown at this time whether any "customer agreement letters" exist between CERS and PIMCO. If they do exist, any proposed amendment should address the contents of these letters. The information required by Government Code section 6932(c)(1)-(5) should be contained therein. In the event no such letters are in existence, we would suggest that PIMCO's proposed annual list be designated as a "customer agreement letter" thus fulfilling the express terms of the statute.

We would like to point out one additional concern with PIMCO's proposed amendment. Paragraph 2 on page 2 states that the proposed amendment "shall affect only those changes referred to above and all other terms and conditions of said Agreement shall remain in force and effect." Paragraph 16, however, of the Agreement provides that "this Agreement shall be governed by the laws of the State of California in effect as of the date of this Agreement." (Emphasis added.) The original Agreement was dated February 23, 1989. Subsequent amendments were dated January 24, 1990 and March 7, 1991. Neither the original Agreement nor the subsequent amendments to that Agreement address the requirement imposed by Government Code section 6931 that "each securities transaction or brokerage arrangement carried out for a governmental investor pursuant to a soft dollar and directed brokerage arrangement, as defined in subdivision (b) of Section 6930, shall be executed at the lowest responsible transaction cost available." This requirement became effective January 1, 1991. As such, paragraph 16 of the Agreement will also have to be amended to reflect the date of any subsequent amendments.

In closing, we note that the requirements of Government Code sections 6930-6934 are applicable to all contracts between CERS and its investment managers. In particular, the specific provisions of Government Code section 6932(c) outlined above must be included in all such contracts entered into, renewed, extended or amended after January 1, 1991.

Please contact us if you have any questions or if we can be of further assistance.

JOHN W. WITT, City Attorney

By

Loraine L. Etherington

Deputy City Attorney

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